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Client Alert

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United States: Beneficial ownership reporting - Part II

In brief

On 8 December 2021, Treasury issued Notice of Proposed Rulemaking to allow the public to review and comment on proposed regulations ("**Proposed Regulations**") to implement the beneficial ownership information reporting provisions of the Corporate Transparency Act (CTA). Passed on 1 January 2021, the CTA imposes on so-called "Reporting Companies" the obligation to report to Financial Crimes Enforcement Network (FinCEN) information regarding their "Beneficial Owners" and company "Applicants." This Client Alert reviews the Proposed Regulations and is a companion to our January 2021 Client Alert that provided an overview of the CTA shortly after it was enacted and which can be found here: Client Alert - Updates on Beneficial Ownership Reporting in the United States.

Contents

The CTA itself does not sufficiently define various terms essential for its implementation. The Proposed Regulations are intended to provide clarification and guidance on the reporting obligations mandated by the CTA. The Proposed Regulations are essential for another reason as well, since the CTA provides that its beneficial ownership reporting requirements take effect ". . . on the effective date of the regulations prescribed by the Secretary of the Treasury."

Below we summarize the Proposed Regulations and draw special attention to FinCEN's clarification of issues of concern for high net worth individuals.

Summary of the Proposed Regulations

Reports Required. The Proposed Regulations divide Reporting Companies into two categories: Domestic Reporting Companies and Foreign Reporting Companies. These two categories of Reporting Company are discussed further below.

Under the Proposed Regulations a Domestic Reporting Company that is formed after the effective date of the final regulations must file its beneficial ownership information report within 14 days of the date that it was formed. Similarly, if an entity becomes a Foreign Reporting Company it must file such a report within 14 days thereafter. The Proposed Regulations provide that any Domestic Reporting Company created before effective date of the final regulations and any entity that became a Foreign Reporting Company before effective date will be required to file a beneficial ownership information report within one year after effective date.

A Reporting Company will be required to file an updated report under the Proposed Regulations within 30 days of any change to information in its prior report to FinCEN. This includes any changes to who is a Beneficial Owner of the company and any changes with respect to the required information of the Beneficial Owners and Applicant. If the Reporting Company was previously exempt from filing a report under the CTA and for any reason ceases to be exempt, this is considered a change under the Proposed Regulations and will require a beneficial ownership information report within 30 days after the exception ceases to apply. If a Beneficial Owner dies, the Reporting

Company will be required to report the new owner who succeeds to his or her interests when the interests pass by intestacy or are distributed to the new owner under a Will or from a trust.

If a report has an error in it, the Proposed Regulations require the Reporting Company to correct the error within 14 days after it was discovered or has reason to know of the error.

Form and Manner of Reports. Reporting Companies are required by both the CTA and the Proposed Regulations to report the following information with respect to their Beneficial Owners and Applicants on the Reporting Company's beneficial ownership information report and on updated reports if there are any changes to this information: legal name, date of birth, residential address for Beneficial Owners, business address for professional Applicants, residential address for other Applicants, and unique identifying number from an acceptable identification document (e.g., unexpired passport number) or FinCEN identifier.

The Proposed Regulations add a requirement not found in the CTA for the Reporting Company to also provide the following information about itself in its beneficial ownership information report (only required by Proposed Regulations): name (including d/b/a), business address, jurisdiction of formation, and unique identification number.

Definition of Beneficial Owner. The CTA defines a "Beneficial Owner" as an individual who, directly or indirectly, either (i) exercises substantial control over the reporting company, or (ii) owns or controls at least 25% of the ownership interests of the reporting company. To clarify this definition, the Proposed Regulations provide guidance on how to interpret the term "substantial control" and "ownership interest" for purpose of identifying beneficial owners.

A. Substantial Control.

The Proposed Regulations set forth three specific indicators of substantial control, followed by a catch-all provision that brings in "any other form of substantial control over the reporting company." The three indicators are: "(i) serving as a senior officer[1] of a reporting company; (ii) authority over the appointment or removal of any senior officer or dominant majority of the board of director (or similar body) of a reporting company; and (iii) direction, determination, or decision of, or substantial influence over, important matters[2] of a reporting company."

FinCEN purposely defines "substantial control" broadly. First, the definition not only covers "de jure authority", but also "de facto authority."[3] Second, FinCEN includes the catch-all provision to capture substantial control exercised in novel and unorthodox ways. Third, the Proposed Regulation language is carefully crafted to ensure that "substantial control" is not limited to the three listed indicators.[4] Last, the Proposed Regulations recognize that substantial control can be exercised indirectly.

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[1] Proposed 31 CFR 1010.380(f)(8) defines "senior officer" as "any individual holding the position or exercising the authority of a president, secretary, treasurer, chief financial officer, general counsel, chief executive officer, chief operating officer, ***or any other officer, regardless of official title, who performs a similar function***." (emphasis added)

[2] Proposed 31 CFR 1010.380(d)(1) provides a non-exhaustive list of "important matters" - "important matters affecting the reporting company, including but not limited to: (A) The nature, scope, and attributes of the business of the reporting company, including the sale, lease, mortgage, or other transfer of any principal assets of the reporting company; (B) The reorganization, dissolution, or merger of the reporting company; (C) Major expenditures or investments, issuances of any equity, incurrence of any significant debt, or approval of the operating budget of the reporting company; (D) The selection or termination of business lines or ventures, or geographic focus, of the reporting company; (E) Compensation schemes and incentive programs for senior officers; (F) The entry into or termination, or the fulfillment or non-fulfillment of significant contracts; and (G) Amendments of any substantial governance documents of the reporting company, including the articles of incorporation or similar formation documents, bylaws, and significant policies or procedures."

[3] FinCEN categorizes the first indicator as "de jure authority" and the other two as "de facto authority." 69934

[4] Proposed 31 CFR 1010.380(d)(1) states that "[s]ubstantial control over a reporting company ***includes***…[the three indicators and any other form of substantial control over the reporting company]." (emphasis added).

Furthermore, the proposed definition of "substantial control" would require companies to report *all* persons in substantial control as beneficial owners. FinCEN admits that this definition diverges from the current Customer Due Diligence Rule (the "**CDD Rule**")[5], and leads to the identification of a much broader range of individuals. The preamble to the Proposed Regulations advises that once the regulations are finalize a subsequent rulemaking project of FinCEN is a revision of the existing CDD Rule.

B. Ownership Interest.

As to an "ownership interest" in a Reporting Company, the Proposed Regulations provide that an individual who directly or indirectly owns or controls at least 25% of the ownership interests of the Reporting Company includes, but is not limited to: an individual who owns an undivided interest jointly with one or more persons; an individual who controls the ownership interest owned by another individual (e.g., by way of a power of attorney); and with respect to a trust that holds the interest of the Reporting Company, a Trustee or other individual (if any) with the authority to dispose of the assets of the trust, a beneficiary of the trust who (i) is the sole permissible recipient of income and principal or (ii) has the right to demand a distribution of or withdraw substantially all of the assets, or the grantor/settlor of the trust if he or she has the right to revoke the trust or otherwise withdraw the assets of the trust.

Note that the above identification of individuals who are considered to have an ownership interest in a Reporting Company is not exclusive. As such, the Proposed Regulations leave as an open issue in many cases the determination of whether an individual has an ownership interest. This particularly problematic with respect to interests in fully discretionary trusts with multiple beneficiaries that hold interests in Reporting Companies (which are the vast majority of trusts that are created). It is not clear from the Proposed Regulations or the CTA whether the beneficiaries of such trusts would be deemed to have an ownership interest in the Reporting Company for purposes of the beneficial ownership reporting of the CTA. Hopefully this will be addressed by the final regulations.

Definition of Company Applicant. As discussed above, the CTA requires a Reporting Company to identify its "Beneficial Owner" and its "Company Applicant." For this purpose, the Proposed Regulations provide a definition of "Company Applicant". Notably, this proposed definition includes (1) "any individual who files the document" and (2) "any individual who directs or controls the filing of such document." Hence, the Proposed Regulations could give rise to a broad exposure of individuals, as it captures both the filing agents[6] and the parties to whom they answer.

Definition of Reporting Company. As noted above, the Proposed Regulations break down reporting companies into either a (A) Domestic Reporting Company, or (B) Foreign Reporting Company.

A. Domestic Reporting Company

A Domestic Reporting Company is a corporation, LLC, or "other entity that is created by the filing of a document with a secretary of state or any similar office under the law of a State or Indian Tribe." Interestingly, this leaves open the question of whether a domestic entity that is not a corporation, LLC, or created by the filing of a document with a secretary of state or any similar office under the law of a State or Indian Tribe would fall within the definition of a "Domestic Reporting Company."

Based on the provisions of the CTA and the Proposed Regulations, there is a strong argument that a structure that is not created by the filing of a document with a state, such as a common law trust created under the law of any of the fifty US states, is not a Reporting Company. However, the trustee, settlor, and beneficiary of a trust would nevertheless need to be included in the report to FinCEN by the Reporting Company if the trust has an "ownership interest" in the company.

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[5] The current CDD Rule limits the reporting of individuals in substantial control to one person.

[6] According to FinCEN, "the company applicant may be an employee of a business formation service or law firm, or an associate, agent, or family member who is filing the document on behalf of another individual."

The preamble to the Proposed Regulations states that the definition of a Domestic Reporting Company was done for clarity and ease of administration as FinCEN notes that it is FinCEN's understanding that all corporations and LLCs are created by the filing of a document with the secretary of state or similar office under the law of a state or Indian Tribe. The preamble also discusses how FinCEN considered defining "similar entity" narrowly to include entities that limit their owners' personal liability under state or Indian Tribe law, or even more broadly to include entities that are legally distinct from their natural person owners, but they found these approaches to be too burdensome and could possibly exclude entities that can obscure their true ownership or control structures.

Treasury notably invited comments on whether their understanding of the creation of entities is accurate.

B. Foreign Reporting Company

A Foreign Reporting Company is a corporation, LLC, or other entity formed under the law of a foreign country and registered to do business in any State or tribal jurisdiction by the filing of a document with a secretary of state or any similar office under the law of a State or Indian Tribe. This definition more clearly captures each entity that is registered to do business in the U.S. and leaves open less room for interpretive differences.

C. Notable Exemptions to Reporting Obligations.

Exempted from the definition of "Reporting Company" are, among other exemptions: (i) Large operating companies that (1) employ more than 20 full-time employees in the United States, (2) has an operating presence at a physical office in the United States, and (3) filed a Federal income tax or information return demonstrating more than $5,000,000 in gross receipts or sales; (ii) entities assisting a tax-exempt entity which is any entity that operates exclusively to provide financial assistance to, or hold governance rights over any tax-exempt entity, which is a US person, beneficially owned or controlled by one or more US persons that are US citizens or lawfully admitted for permanent residence, and derives at least a majority of its funding or revenue from one or more US persons that are US citizens or lawfully admitted for permanent residence; (iii) tax exempt entities such as entities described in section 501(c) of the IRC; and (iv) accounting firms such as public accounting firms registered in accordance with section 102 of the Sarbanes-Oxley Act of 2002 (15 U.S. C. 7212).

It should be noted that the definition of US person used in the proposed rulemaking is the definition given by Section 7701(a)(3) of the IRC. Section 7701(a)(3) states a US person is a citizen or resident of the United States, a domestic partnership, domestic corporation, any estate, and any trust if a court within the US is able to exercise primary supervision over the administration of the trust and one or more US persons have the authority to control all substantial decisions of the trust. This definition may not encompass people who have taken treaty positions to not be a US resident as they have a closer connection to another State or are here on a student visa or other similar exceptions.

Conclusion

Due to lack of a clear rules applicable to irrevocable discretionary trusts and other variables in beneficial interests under a trust, it is likely that a Reporting Company will assume a very significant burden to "over-comply" with the Proposed Regulations. There were over 230 comments provided by various professional organizations and others with respect to FinCEN's questions raised in the Proposed Regulations. It is the expectation that some of these comments will ease the reporting requirements in the final regulations. But regardless, with the decision of FinCEN to override the current CDD rules and the broad provisions of the CTA itself, entities that fall within the definition of Reporting Company should begin to consider who their Beneficial Owners are and gather the information that they will need to report once the effective date of for CTA reporting is set by the final regulations issued by Treasury.

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